

This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: NBER International Seminar on Macroeconomics 2007

Volume Author/Editor: Richard Clarida and Francesco Giavazzi, organizers

Volume Publisher: University of Chicago Press

ISSN: 1932-8796

Volume URL: <http://www.nber.org/books/clar07-1>

Conference Date: June 15-16, 2007

Publication Date: January 2009

Chapter Title: Comment on "The Simple Geometry of Transmission and Stabilization in Closed and Open Economies"

Chapter Author: Richard Clarida

Chapter URL: <http://www.nber.org/chapters/c3001>

Chapter pages in book: (117 - 118)

Comment

Richard Clarida, Columbia University and NBER

This paper provides a simple, but informative, framework for understanding monetary policy choices in the open economy. The framework features a two-period, two country analysis and, as the title indicates, highlights the geometric intuition behind the results. The paper compares and contrasts the cases of

- Closed and open economies
- Flexible and preset prices
- Producer and local currency pricing
- Nash and cooperative equilibrium

The paper builds on prior work, in particular Cole and Obstfeld (1991) and Corsetti and Pesenti (2001). A key feature of the modeling strategy is to assume common Cobb Douglas preferences across countries so that adjustments in the goods market clearing terms of trade can bring about complete risk sharing without elaborate set of asset markets. In this model, notwithstanding transitory country-specific shocks, trade will be balanced period by period. While this would obviously not be the best model for studying fiscal policy or investment fluctuations, it does seem that abstracting from current account imbalances in a study of monetary policy is not a major shortcoming.

In models such as this, there are two distortions that work in opposite directions. Markups put a wedge between price and marginal cost so that equilibrium output is too low. However, the endogenous terms of trade means that country welfare can be improved by reducing output below the competitive equilibrium level, so that output may be too high.

Is there value in such a simple, unified framework? I think the answer is yes. The paper is especially effective in developing the intuition for the crucial differences between producer and local currency pricing, opti-

mal policy in closed versus open economies, the gains from commitment, and inflation versus disinflation bias in the open economy. Is there value in the geometric approach? Sometimes, but other times, the geometry only made sense (at least to me) once I worked through the math.

The paper is self-contained as is, but here are suggestions for some possible extensions in future work. Could the simple geometry accommodate non tradable goods, to get at Balassa-Samuelson interactions? Could it accommodate home bias in consumption? Most importantly, can the simple geometry allow for demand shocks—say, balanced budget financed government demand for home output?

In sum, this paper adds to an impressive and influential body in international monetary economics, and it will be required on my Ph.D. reading list. For those who think intuition is for undergrads, I say think again!